View metadata, citation and similar papers at core.ac.uk

brought to you by CORE

provided by eGrove (Univ. of Mississippi)

University of Mississippi
eGrove

Statements of Position

American Institute of Certified Public Accountants (AICPA) Historical Collection

1976

Accounting practices in the recorded and printed music industry; Exposure draft (American Institute of Certified Public Accountants), 1976, Feb. 4

Institute of Certified Public Accountants. Accounting Standards Task Force on Entertainment Companies

Follow this and additional works at: https://egrove.olemiss.edu/aicpa_sop

Part of the Accounting Commons, and the Taxation Commons

Recommended Citation

Institute of Certified Public Accountants. Accounting Standards Task Force on Entertainment Companies, "Accounting practices in the recorded and printed music industry; Exposure draft (American Institute of Certified Public Accountants), 1976, Feb. 4" (1976). *Statements of Position*. 357.
https://egrove.olemiss.edu/aicpa_sop/357

This Book is brought to you for free and open access by the American Institute of Certified Public Accountants (AICPA) Historical Collection at eGrove. It has been accepted for inclusion in Statements of Position by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.

ACCOUNTING PRACTICES IN THE RECORDED AND PRINTED MUSIC INDUSTRY

A Proposed Recommendation to the
Financial Accounting Standards Board

EXPOSURE DRAFT

This exposure draft has been prepared by the Accounting Standards Task Force on Entertainment Companies for public comment. It has not been reviewed or approved by the Accounting Standards Division or any of its other components. It has been distributed to members of the Accounting, Auditing and Federal Taxation Executive Committees of the AICPA and to certain organizations outside the accounting profession. Copies are available to interested persons and organizations upon request.

Comments should be sent, in time to arrive not later than March 31, 1976, to —

Thomas P. Kelley, CPA
Director, Accounting Standards
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036

TABLE OF CONTENTS

GENERAL BACKGROUND

Record Manufacturing

General Description

The record industry consists of numerous entities, from small operations to substantial divisions of large companies. It has certain unique characteristics. First, success in it depends to a large extent on acceptance by the public of the creative efforts of third-party composers and performers. Since such acceptance is frequently of very short duration, there is a need for prompt saturation of the marketplace to maximize revenues. (Classical and other music which has achieved sustained public acceptance are exceptions to this general rule.) Second, a relatively high portion of the manufacturer's costs consists of royalties or fees which are generally, but not always, based on net sales.

A record manufacturer normally enters into a contractual arrangement (a) with the artist (performer) and possibly with a producer to record a given number of selections over a specified period of time, or (b) with a production company to deliver finished record masters of one or more artists. The phonograph discs and tapes (hereinafter referred to collectively as "records") are then produced and shipped for ultimate sale to the customer. The manufacturer may own or be affiliated with the pressing plant, the tape duplicator, the distributor and the retailer, or with some or none of these.

The manufacturer will usually grant licenses for the sale or distribution of its products to record clubs and other direct mail operations and, for sales throughout the world, to one or more companies active in the industry in foreign countries. Again, the manufacturer may own or be affiliated with all, some or none of the licensees.

The Record Master

A performance is initially recorded on magnetic tape. Usually, each musical instrument and voice is recorded separately and then re-recorded to emphasize or deemphasize each sound in the final product. Such a process, called mixing, is performed by an expert sound engineer to produce a master tape, which is the "record master." The record master, in turn, is used to produce an acetate disc which is subsequently coated with metal and used to produce the molds or stampers used in commercial record production. In addition, the record master is used to make other tapes from which commercial tape cartridges, cassettes and reels may be produced.

The costs of producing a record master include (1) cost of the musical talent, (musicians, vocal background and arranging), (2) cost of the technical talent for engineering, directing and mixing, (3) costs for the use of the equipment to record and produce the master, and (4) studio facility charges.

Marketing

The current marketing of recorded and printed music includes the following levels of distribution:

- Manufacturers, as discussed above, contract with artists for the recording of selections, arrange and finance the actual recording and provide for the pressing of records and duplication of tapes or sheet music. Manufacturers generally sell to distributors, wholesale merchandisers and record clubs.

- Distributors usually sell the products of a limited number of manufacturers to wholesale merchandisers, record stores and other retail outlets.

- Wholesale merchandisers, sometimes called subdistributors or rack jobbers, function as service agencies for the music departments of chain stores and other retail outlets by supervising individual store inventories, selecting titles and labels, determining quantities to be ordered, and sometimes developing advertising and promotional programs. Wholesale merchandisers usually sell the products of a variety of manufacturers and the services they provide are not normally offered by the distributor.

- Retail outlets purchase from the aforementioned suppliers and sell directly to the ultimate customer. Retail outlets include record stores, the music departments of chain and discount stores, and record clubs.

- Record clubs came into existence in the 1950's and serve as a direct line from the record manufacturer to the ultimate customer. Record clubs, including those operated by a manufacturer, commonly distribute the records of more than one manufacturer and normally offer a number of "free" records (records given free of charge or at a nominal price) as an inducement to join, subject to the new member's agreeing to purchase a certain number of records at or near retail list prices.

- Compilation records are normally manufactured from masters embodying recordings of one or more artists by one or more record manufacturers. They include more than the usual number of selections per record, are sold at prices below those charged for the original records, and are generally offered through television and radio advertising. The customer may purchase the record through the mail or directly from a designated retail outlet.

Recording Artist Contracts

As stated previously, a record manufacturer employs artists under personal service contracts. The major portion of artist compensation is comprised of royalties (measured by sales and license fee income) and/or non-refundable advances against royalties based upon contractual terms negotiated between the parties. The artist may agree to bear a portion or all of the costs of the record master and the manufacturer may then recoup that amount from artist royalties otherwise payable. The extent of such arrangements depends on the relative bargaining strength of each party. However, such advances and costs are generally not recoupable from the artist if royalties do not cover them.

Generally, in connection with recordings made in the United States, payments are also made to various union funds under contractual arrangements which measure the obligation on the basis of sales activity. Foreign artists recording in studios outside the United States are exceptions to this rule.

Music Publishing

General Description

The music itself, as opposed to a given recording, is normally controlled by a music publisher. Publishers are sometimes controlled by a record manufacturer, but in most instances publishers are either affiliates of the artist or independent.

The publisher normally obtains the rights to music from composers with the objective of exploiting the music for its maximum revenue. At one time, most music publishers were small, independent entities. Lately, however, there have been two trends: one toward merger with and ownership by record manufacturers, the other toward ownership by composers, who in many cases are recording artists as well.

The publisher's two prime sources of revenue are royalties from record companies and royalties from public performances for profit. Other sources include revenue from the use of music in motion pictures and from the sale of sheet music.

Royalties

Copyright royalties to publishers are based on the U. S. Copyright Law, but the requirements of the law are normally modified by licenses issued by the publishers. By statute, royalties to publishers are due monthly at $.02 per selection based on quantities manufactured, whereas licenses often provide for quarterly accountings at stipulated rates (which are sometimes less than $.02) based on quantities sold. Substantial changes in the Copyright Law have been suggested and a new Act has been introduced in the last several sessions of Congress which may, if enacted, materially affect copyright and, possibly, other royalties. If copyrights have not been obtained or have expired, the music is in the public domain and no royalties are payable.

Music publishers are normally affiliated with a collection society for collection of public performance revenue, either ASCAP (American Society of Composers, Authors and Publishers) or BMI (Broadcast Music, Inc.). These societies collect from television and radio stations, the primary source of public performance revenue, as well as from other sources, such as live performances. Stations may supply these societies with broadcasting logs and may be monitored on a test basis. By formula and allocation, the societies determine revenue for each selection and normally pay both publishers and composers their shares directly.

Music publishers in most instances have another organization act as their agent for licensing record companies and other users, collecting royalties and verifying the accuracy of the royalties paid. Publishers may sell their own sheet music or may license others to do so for a royalty.

Foreign income arises from the same sources (broadcasting, live performances, sheet music, etc.). However, U. S. publishers normally grant foreign publishers exclusive rights in specific territories for varying percentages of the revenue earned in the territory.

The music publishers, in turn, normally pay composers a share of the royalty receipts (excluding performance income which is usually paid directly by the collection society) and a flat rate per unit in the case of sheet music.

REVENUE RECOGNITION

Industry Practice

The timing of revenue recognition and the determination of the amount of revenue to be reported for a given period of time can be an accounting problem because of the right of return that normally accompanies sales in the recorded and printed music industry.[1/] These return rights can vary from unlimited to a percentage of sales, or may be in the form of exchange privileges which permit the customer to receive other records for those returned. Regardless of the form of arrangement between supplier and customer, sales are generally made with the right to return or exchange, subject to time limits that the manufacturer may establish, such as when the specific record is deleted from its catalog. These return or exchange practices have been established by manufacturers to induce customers to carry larger inventories than they might otherwise maintain in an industry subject to

1/ Although the discussion which follows deals solely with records, similar practices and problems are found in the printed music industry.

volatile swings in consumer preferences. In addition, when a manufacturer changes a distributor, it is customary to permit the former distributor to return all of the manufacturer's records for credit.

It is the predominant practice in the industry to record sales when inventory is delivered and the customer is obligated to pay for the merchandise in accordance with normal trade terms.

Some manufacturers discount the price of records by including a number of "free" records in certain shipments. Credits issued for returned records give recognition to such "free" records either by using the average selling price or by reducing the total units returned in proportion to the number of "free" records included in the original shipment.

Because of the return or exchange privilege, manufacturers and distributors usually make a provision in their financial statements for the anticipated return of records from current and prior sales. The resultant allowance for returns is usually combined with the allowance for doubtful accounts and deducted from trade receivables in the balance sheet. In the income statement, the provision for returns is generally netted against gross sales recorded for the period, but is sometimes classified as "sales returns and allowances." However, in some cases the sales transaction is reversed and an inventory established, or a liability is accrued for the return privilege. The determination of the amount of anticipated returns is based on many factors, including historical experience, popularity of the music recorded, success of the recording artists, marketing techniques, etc.

Some manufacturers and distributors (who have return privileges with manufacturers) do not provide in their financial statements for return privileges granted to their customers and recognize losses, if any, arising from returns only when they are incurred.

The Division's Conclusion

The question of revenue recognition when right of return exists has been discussed in Statement of Position No. 75-1 of the Accounting Standards Division of the AICPA. That Statement holds that "...if a seller is exposed to the risks of ownership through return of the property, the transaction should not be recognized currently as a sale unless all of certain specified conditions are met." These conditions and their applicability to the recorded and printed music industry are discussed below.

"(1) The seller's price to the buyer is substantially fixed or determinable at the date of exchange."

> Sales prices are normally fixed at the date of exchange in the recorded and printed music industry.

"(2) Either the buyer has made full payment, or the buyer is indebted to the seller and payment is not contractually or implicitly excused until such time as the product is resold."

> Payment for merchandise in the recorded and printed music industry is usually required within thirty days under the terms of sale, or, in the case of deferred billing, within sixty to ninety days of shipment.

"(3) The buyer's obligation to the seller would not be changed in the event of theft or physical destruction or damage of the property."

The risk of loss with respect to recorded and printed music merchandise is transferred to the buyer under usual trade practices upon transfer of physical possession of the merchandise.

"(4) The buyer acquiring for resale has economic substance apart from that provided by the seller; that is, the buyer is not a straw party or a conduit."

It would not be common to find a buyer who is a straw party or a conduit in the recorded and printed music industry.

"(5) The seller does not have significant obligations for future performance to bring about resale of the property by the buyer."

The seller would not normally undertake obligations to bring about resale of the property by the buyer in this industry.

While each of the five conditions listed above must be met, and generally are met, and while the usual conditions for recording sales not involving the right of return must also be satisfied, the final condition set forth in Statement of Position No. 75-1 is troublesome: "(6) The amount of future returns can be reasonably predicted."

The Statement of Position acknowledges that the "ability to make a reasonable prediction of the amount of future returns is dependent on the existence of many factors," and that "only general guidelines can be established." It lists five factors which "would appear to impair the ability to make a reasonable prediction," all of which must be considered; however, the factor that requires the most consideration in the recorded and printed music industry is the following:

> "Absence of historical experience with similar types of sales of similar types of property, or inability to apply such experience because of changing circumstances."

Rates of return in the recorded and printed music industry vary from company to company and from year to year. While very little information is published regarding the dollar value of returns and there are presently no published industry statistics, the Division believes that returns normally range from 15% to as much as 30% of sales. Nevertheless, high volume and reasonably stable rates of return have usually enabled established companies to estimate returns with reasonable accuracy on the basis of their own historical experience. However, companies expanding to a different type of music (classical, jazz, rock, etc.) and companies engaging a large number of unproven artists, among others, may not possess sufficient historical experience of their own on which to make a reasonable prediction of future returns.

In those instances where a company's historical experience is not applicable to the sales in question or where a company is new and has no historical experience, the Division has concluded that applicable industry experience, if obtained in sufficient detail, may serve as a basis for determining a reasonable return percentage.

The Division acknowledges the inherent difficulty at the present time of obtaining sufficient industry information about returns. Nevertheless, the Division reaffirms the conclusions set forth in Statement of Position No. 75-1 and thus believes that when manufacturers and distributors in the recorded and printed music industry account for shipments to customers as sales, provision should be made immediately (on the basis of historical experience or industry information, as appropriate) for costs or losses expected to be incurred in connection with estimated returns.

The Division recognizes that certain types of music may be susceptible to dramatic swings in popularity; that artists may have no prior experience and uncertain futures; that the market for certain types of music may be monopolized by a few artists; that distribution channels may be narrow and promotional endeavors limited; and that the quantity of returns may be large when a manufacturer changes a distributor. All of these conditions create difficulty in making a reasonable estimate of the amount of future returns. When the presence of such conditions precludes a manufacturer or distributor from utilizing historical experience or industry data to make a reasonable prediction of the amount of future returns (a situation which the Division believes will be unusual), the transactions should not be recognized currently as sales. Transactions for which sales recognition is postponed should be recognized as sales when the return privilege has substantially expired.

The Division also believes that the accounting recognition for estimated returns should include adjustment of sales, accounts receivable, inventories, accrued royalties, cost of sales, etc. This will result in including in inventory amounts for products expected to be returned, which should be disclosed.

Because sales returns are a significant factor in determining the results of operations in the recorded and printed music industry, the amount of gross sales, the related accounting policies and the percentage of returns provided in relation to sales should be disclosed in the financial statements or the notes thereto.

INVENTORY VALUATION

Industry Practice

Inventory valuation in the recorded and printed music industry is difficult because of the severe obsolescence problem resulting from changing consumer tastes and return or exchange practices. This problem is even more pronounced when the inventory valuation of returned records is being determined. For this reason, some companies assign no value to returned records. Others carry them at estimated salvage value, cost, or the lower of cost or market. The valuation policy may depend on whether the records are singles, LP albums or tapes. In addition, the determination of market value is complicated by the existence of two markets: one for the resale of records on a marked-down basis, and another for the scrap value of the physical components.

The Division's Conclusion

The valuation of inventories in this industry should be similar to that of any other manufacturing concern. Inventories, including records expected to be returned, should be carried at the lower of cost or market and, at a minimum, inventories of salable records and inventories of records to be scrapped should be separately valued. The market value of records to be scrapped should be their expected net salvage value. The market value of records expected to be sold should be their net realizable value. (Although manufacturing cost is usually minor relative to the selling price of most records, cost may exceed net realizable value when drastic reductions to selling price have been made.) The method of determining cost should be disclosed and raw materials, lithos, jackets, collated records and tapes might be appropriate components to be identified. Records and jackets are often accounted for as separate elements of inventory and are sometimes stored separately at various plants; these costs should be considered together in cost to market comparisons.

COMPENSATION OF ARTISTS

Industry Practice

As noted elsewhere in this Statement, artists are usually compensated on a royalty basis; the royalty provisions are set forth in the artist's contract and may vary substantially among artists, since they depend on the artist's bargaining power.

Generally, the total amount of royalty accrued (adjusted for anticipated returns) is charged to expense in the period in which the sale of the record takes place. However, the accounting for advances paid to artists which are recoupable out of future royalties is not consistent among companies. The common alternatives are summarized below:

(1) The advance is recorded as an asset with subsequent royalties earned offset against it until the advance has been fully recovered or determined to be unrecoverable. Some believe this method achieves the best matching of revenue and expense.

(2) The advance is recorded as an asset but expensed when the record is released. Some believe this is a practical method to achieve a reasonable matching of revenue and expense, since the bulk of record revenues are received in a relatively short period of time.

(3) The advance is recorded as expense when paid by those who emphasize the difficulty of predicting the sales of a particular record.

(4) The advance is included as part of inventory cost by those who believe that such advances are another element of the cost of producing a record and should be amortized on the same basis as any other recording cost.

The Division's Conclusion

The Division believes that advances should be recorded as an asset and subsequent royalties earned by the artist should be applied against it until the advance has been fully recovered. However, it is a generally accepted accounting principle that losses should be provided for when they become evident. Therefore, as soon as it is estimated that all or a portion of the unrecouped advance will not be recovered from future royalties earned by the artist, that portion of the advance should be charged to expense.

In determining whether or not the asset is recoverable, management should evaluate its experience with the artist, the success of the particular release, market trends, contractual or other arrangements, and other pertinent information available prior to issuance of the financial statements. The right to recoup advances from a number of records of an artist may complicate the recoverability determination. However, failure to recover a proportionate amount of the advances from royalties payable on each release would normally establish a presumption that at least a portion of the advance should be written off.

Commitments for artist advances payable in future years and future royalty guarantees should now be disclosed in the financial statements or notes thereto, if material, and evaluated currently to determine if a loss provision is required.

Inasmuch as artist royalties, as well as copyright and other royalties, are generally a significant cost, a careful review of the contracts and possible interpretations thereof is essential to a determination of an appropriate accrual.

COSTS OF RECORD MASTERS

Industry Practice

Under the standard type of artist contract, the costs of producing a record master can be separated into costs borne by the record company and costs recoverable from artists out of designated royalties earned. Typically, the stronger party to the contract bears a lesser portion of the costs; the more successful artists often do not bear any of the costs of record masters. On the other hand, recoupment of costs recoverable from the artist may not always be limited to royalties on a specific record.

The portion of the costs of a record master recoverable from artists is accounted for as a royalty advance using one of the methods discussed in the section on "Compensation of Artists."

Several methods are employed to account for record master costs borne by the record company:

(1) Record the cost of the record master as an asset and amortize it on the income forecast method. Advocates of this approach believe that it achieves an appropriate matching of income and expense.

(2) Defer the cost of the record master and charge it to expense in the period of the record's initial release. Supporters of this approach believe that it is a practical method to achieve a reasonable matching of revenues and expense. Since the bulk of record revenues are derived within the first six months of release, they believe this method matches costs with revenues unless the release is near the end of an accounting period.

(3) Expense the cost of the record master when incurred. Those who believe this approach is appropriate point out the difficulty of predicting the sales of a <u>particular</u> record.

(4) Include the cost of the record master as part of inventory cost. Those who prefer this alternative believe that the cost of a record master is another element of the cost of producing a record and should be amortized on the same basis as any other recording cost.

The Division's Conclusion

The Division believes that the cost of the record master borne by the record company should be recorded as an asset and amortized. The amortization method should reasonably relate the cost of the record master to the net revenue realized. This may be accomplished by the income forecast method applied to individual records or by other methods which achieve similar results. The Division believes that records, other than those of classical and other music which has achieved sustained public acceptance, have a very short life and costs relating thereto should be amortized accordingly. The costs recoverable from artists should be accounted for as an advance as discussed in the preceding section.

LICENSOR INCOME/LICENSEE COST

Industry Practice

As noted in a previous section of this Statement, substantial revenues may be realized by the owner of a record master or copyright by licensing it to third parties. Minimum guarantees are usually paid in advance by the licensee. Additional payments are normally required if license fees based on actual sales exceed the minimum guarantee.

Licensors treat such guarantees as either:

(1) Revenue when received;

(2) An advance, allocated ratably over the period covered by the guarantee; or

(3) Revenue to the extent of the portion earned during the reporting period, reflecting unearned balances, if any, as income at the expiration of the period covered by the license agreement.

Licensees treat minimum guarantees as costs using similar methods.

When no minimum guarantee is received, or when actual license fees exceed the minimum guarantee, revenue is not normally recognized by the licensor until an accounting is received from the licensee.

In certain situations, other fees may be required under the license agreement. For example, further payments may be required from a record club if it ships "free" records in a quantity which exceeds a specified percentage of sales of the licensor's records over the term of the agreement. Such fees have generally been recorded as revenue by the licensor and as expense by the licensee upon expiration of the agreement.

The Division's Conclusion

The Division believes that in most cases licensors should record minimum guarantees as deferred income to be amortized ratably over the performance period, which is generally the period covered by the license agreement. This conclusion relates the recognition of revenue to the performance of services which, in this case, is the right given the licensee to use the music or to sell the record during the license period. It acknowledges that the licensor has an irrevocable right to the minimum guarantee and also implicitly acknowledges that in many cases it is impossible for the licensor to ascertain whether the actual amount of license income earned under the terms of the agreement exceeds a ratable portion of the minimum guarantee. (This is particularly true with respect to foreign licensees, who frequently do not render accountings on a timely basis.) However, when the licensor can determine that license fees earned under the agreement exceed a ratable portion of the minimum guarantee, it is appropriate to record that greater amount in income.

In some cases, however, a license agreement may be in substance an outright sale. When the licensor has signed a noncancellable contract, has delivered the rights to the licensee, has no remaining significant obligations for performance, and has agreed to a fixed license fee, the earnings process is complete and the fee may be taken into income when collectibility of the full fee is reasonably assured. In such circumstances, neither the licensee's use of the rights transferred nor the passage of time during the license period has any significance in relation to the recognition of the license fee in income.

The Division believes that in making a reasonable determination of earnings for the period, annual financial statements should include, wherever possible, estimated revenue for a full year from each significant license (assuming the license has been in effect for a year or more). A proportionate amount should be included in interim financial statements.

The licensee should record minimum guarantees as a deferred charge and license fees determined in accordance with the terms of the agreement should be applied against it until the deferred charge is eliminated. However, as soon as it is estimated that all or a portion of the minimum guarantee will not be amortized through future use of the rights obtained under the license, that portion of the minimum guarantee should be charged to expense.

The Division believes the licensor should not recognize in revenue the other fees (e.g., those for excess "free" records) discussed previously under "Industry Practice" until the agreement has expired and the amount is fixed and determinable. Prior to the expiration date of the agreement, the licensor normally would have no information as to the number of "free" records distributed. In addition, an estimate of income based on such information, if available, would be contingent on future events. However, the licensee should provide for such expenses on a license by license basis for each period covered by the respective financial statements.

Appropriate consideration should be given to matching artist royalties and other costs to recognition of revenue from licensees.

INTANGIBLE ASSETS ACQUIRED IN A BUSINESS COMBINATION

The acquisition of a record manufacturer or music publisher in a business combination accounted for as a purchase normally entails, among other things, the acquisition of various intangible rights and assets such as record masters, unexpired artist contracts and copyrights. These rights and assets are normally specifically identifiable and have determinable lives and, therefore, should be recorded in accordance with APB Opinion No. 17, paragraphs 24 to 26.

The Division believes that, in most situations, a reasonable determination can be made as to the proportionate share that each type of asset bears to the total purchase price; as a result, goodwill would normally not be expected to be a significant factor. Accordingly, a proper allocation of the purchase price should be made for financial statement purposes in accordance with APB Opinion No. 16, paragraph 68, based on fair value. Appropriate amortization over the useful life (as opposed to the legal life) of each such type of asset should be provided. The Division believes that the income forecast method for computing amortization of these intangible assets would be appropriate. However, where the asset consists of a large number of items with varying useful lives, an overall amortization schedule would be an acceptable practical approach.

MUSIC PUBLISHERS

The problems, practices and recommendations discussed elsewhere in this Statement are applicable to music publishers, where appropriate.

However, the Division recognizes that all or substantially all of a music publisher's revenues are from licensees. Accordingly, the recommendation that such revenue should be recognized as soon as practicable and should reflect a full year's earnings from material licensees for each annual financial statement is emphasized.